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U.K. Holds Firm to Monetarism

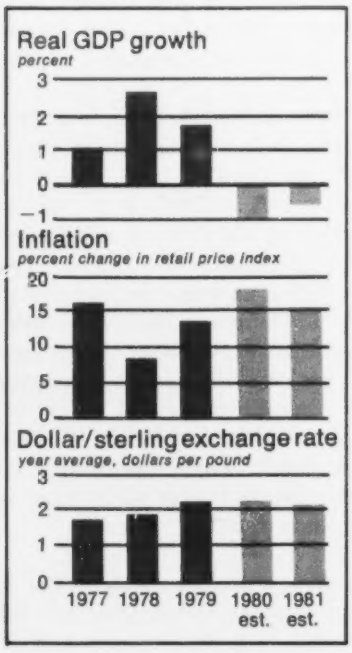
The Thatcher Government has underscored its commitment to monetarism, evidenced by the two highly restrictive budgets introduced since the Conservatives came to power in 1979. The commitment to monetarism is expressed both in the narrow sense of restricting money growth, and in the broader sense of reducing the role of the Government, encouraging individual initiative, and allowing market forces to operate more freely. The hope is that such a policy approach will bring down inflation and foster an increase in productive capacity matched by a larger rise in private demand—ultimately generating prosperity and full employment.

The British authorities plan to reduce steadily the volume of public expenditure and the rate of money growth over the coming years. While income taxes have already been cut, with the maximum rate down from 85% to 60%, social security benefits will be restricted. Such policies represent a major shift from those of previous governments. It thus remains an open question whether or not they will eventually succeed in changing the populace's economic thinking and improving the country's hitherto poor economic performance.

What is clear is that the next two years will be difficult ones. Output already began to slow in 1979, ending the year with a real GDP growth rate of only 1.7%, compared with 2.7% in 1978. And the combination of reduced government spending and high interest rates will lead to absolute declines in economic output in both 1980 and 1981. Earnings have been rising at an annual rate of some 19% over the last few months, and with retail prices also posting increases of nearly 20%, it seems doubtful that wage demands will be greatly moderated when the annual wage round commences in July. Since containing inflation is the Government's overriding objective, it is apparently determined to keep to its goal of holding annual money supply growth to no more than 11%. Corporate profits will therefore be severely squeezed, and unemployment is expected to rise rapidly.

One of the few near-term bright spots, however, is the pound's exchange rate. A generalized realization that Britain will become self-sufficient in oil during 1980, and a net exporter thereafter, has greatly increased investment demand for sterling. Capital inflows were $7.8 billion in 1979, which helped to raise U.K. reserves from $15.7 billion at the start of the year to $22.5 billion at year-end. Sterling has been strengthened further by a monetary policy that has pushed British interest rates well above those available in most other countries.

U.K. indicators



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French credit-tightening policy complicated by EMS obligations.

Signs of continued economic buoyancy are worrying French authorities about the build-up of inflationary pressures. Consumer price index hikes of 1.9% in January and 1.1% in February have now brought the index to 13.4% above its year-ago level. And latest indicators reveal a surge in monetary growth at the end of 1979. M_2 rose 1.6% in December, bringing the year-over-year increase to 14.2%. The target growth rate for 1980, by contrast, is 11%. Accordingly, new measures have been introduced to rein in credit growth, a policy consistent with Prime Minister Barre's commitment to a strong exchange-rate policy. Categories of lending previously exempt from controls have been progressively reincorporated. Beginning May 1, 50% of such lending for export credit and energy-saving purposes is to be subject to the credit-control system guidelines, as against only 30% just last fall. Home purchase credit will now be wholly included. Recent German mark weakness, however, has pushed the French franc to the top of the European Monetary System's currency band, posing a dilemma for French authorities. Domestic monetary policy is increasingly at variance with the need to keep the franc within its EMS intervention limits. Thus, commitment to the EMS may force the French to compromise on further credit tightening.

Finnish growth remains high, but inflation threatens.

Finland's economy is now slowing down, after posting 8% growth in 1979. Still, the country expects to remain one of the fastest growing OECD members, with GDP growth of about 4.5% projected for 1980. A major economic problem is the acceleration of inflation. The rate of price increase rose to 9% in January, after averaging 7.4% in 1979, and has made recent wage negotiations the most difficult in many years. The central bank has sought to moderate the inflationary impact of higher import prices by revaluing the Finnish markkaa, whose value, after the latest 2% revaluation of March 26, is some 4.6% above its year-ago level. But relatively high wage settlements and a balance-of-payments deterioration are complicating inflation-control efforts. During 1979, the current-account deficit was 1.1 billion markkaa, and the overall payments deficit was about 2.3 billion, following surpluses of 2.5 and 3.0 billion markkaa, respectively, in 1978. Moreover, the trade figures for the first two months of 1980—indicating a deficit of 1.1 billion markkaa, versus a surplus of 0.3 billion for the year-earlier period—suggest that a further deterioration in the balance of payments can be expected in 1980.

A rough year ahead for Spain's deteriorating economy.

The Spanish economy performed poorly in 1979, and is likely to deteriorate further in 1980. Faced with weak domestic demand and a slowdown in the world economy, economic growth fell from 3% in 1978 to about 1% in 1979, and the country is likely to see growth of no greater than 0.5% in 1980. As of the end of 1979, 1.33 million Spaniards were out of work—over 10% of the working population. And unemployment is projected to exceed 1.5 million in 1980 as the economy stagnates further. At the same time, the inflation outlook has deteriorated. Although the average rate for 1979 was down to 15.7% from 19.8% in 1978, rising fuel costs and the recent weakening of the peseta are expected to add to inflationary pressures throughout 1980. Rising fuel costs have also played havoc with the external accounts. Although a current-account surplus of some $1 billion was expected for 1979, latest Bank of Spain estimates indicate that higher oil prices pushed the actual account into a deficit of $800 million, which represents a deterioration of $2.5 billion from 1978. And a further rise in the oil bill is expected to increase the current-account gap to $2.5-$3.0 billion in 1980.

Malaysian economic growth continuing strong.

Malaysia posted real GNP growth of 8.5% in 1979, a healthy rise from the already strong 7.6% rate of 1978. Inflation-adjusted national income grew an even faster 15%, reflecting a strong improvement in terms of trade. Private-sector expenditures rose 11.4% in 1979, led by strong export earnings, high demand for residential and commercial buildings, and continued improvement in the investment climate. Public-sector expenditures also increased sharply, by 12.4%. The increased public spending is related to efforts to meet the socioeconomic targets

of the third five-year Malaysian plan, which runs through 1980. On the external front, export earnings were up 12.1% in real terms last year, versus 7.9% in 1978. Despite an 18.3% rise in imports, spurred by strong domestic consumption and investment demand, the country's current-account surplus was pushed over $1 billion, compared with $115 million in 1978, thanks to a 14.5% improvement in terms of trade. Export growth is expected to slow significantly this year, in response to the worldwide economic downturn, but continued strength in the resource-rich domestic economy should be sufficient to sustain overall economic growth of 7% or better in 1980.

Mexican oil production targets boosted.

Aided by continuing increases in its oil discoveries and output, the Mexican Government has raised its oil production targets through 1982 by 10%. By the end of 1980, oil output should reach 2.25-2.50 million barrels per day (bpd)—the target previously set for 1982. The new target for 1982 is now 2.70 million bpd. The higher production rate will satisfy increased domestic needs as well as assure an export level of over one million bpd through 1982. Larger oil export volumes—combined with higher oil prices—will enhance the Mexican trade accounts considerably this year, and help reduce last year's $3.2-billion merchandise trade deficit. And even assuming a sustained rapid pace of import growth, the higher levels of petroleum export earnings anticipated should help bring about a trade surplus by 1981.

Iran striving to increase its economic independence.

The Iranian economy is in the midst of a major restructuring. Iranian authorities have launched the new Iranian year with budgeted expenditures about 10% lower than last year and 25% less than the pre-revolution level. (One-third of expenditures are allocated to development projects, the same proportion as last year.) Domestic economic policies are geared to reducing dependence on Western economies, particularly in the wake of the Carter Administration's new sanctions. Agricultural prices for producers have been raised to stimulate production and lower food imports, and a substantial increase in acreage planted has been reported. On the oil front, the country's petroleum minister has announced that oil output for the next 12 months will average 3 million barrels per day, only half the peak reached prior to the revolution, and one-half million barrels per day less than production levels over the last three months. At the same time, Iran has sought to boost its price further, to some $34.50 per barrel, but it has encountered resistance in view of the high level of world oil stocks. Meanwhile, further pressure has been placed on the United States' European allies to join the economic boycott of Iran. If the boycott is indeed widened, Iran's economy will probably suffer a number of further shortages, but the economic impact is not likely to be far reaching.

Bumper crop for cocoa will add to downward price pressures.

With continued favorable growing conditions and new plantings, world cocoa production is expected to reach a record 1.59 million metric tons in the 1979-80 growing season, some 7% higher than the 1978-79 crop. Coinciding as it does with a period of increasingly sluggish demand, a bumper crop this year will mean another surplus in the cocoa markets—the third in as many years—and further downward pressure on cocoa prices. With the expiration of the International Cocoa Agreement in March, ten nations, responsible for about 90% of the world's cocoa output, have formed an alliance with the aim of supporting prices at roughly their current level. Although cocoa bean prices have fallen nearly 50% from their mid-1977 peak, they are still high by historical standards and this is contributing to a steady erosion of cocoa consumption, leading chocolate manufacturers to increase their usage of cocoa substitutes and extenders and to shift production to non-chocolate confectionary items. Moreover, economic slowdowns in the major cocoa-consuming nations are likely to weaken demand still further. Thus, the world's cocoa producers may find it increasingly difficult to support prices over the coming months.

Interest Rates Take A Dive

Interest rates have plummeted during the last three weeks. In part this decline has been in response to information suggesting that the U.S. economy is a good deal weaker than was believed last month. Slower-than-expected money growth and indications of a possible lowering of the Federal Reserve's trading range for the Federal funds rate have also been major contributors to the rate declines. While the market appears to be expecting short-term rates to fall even further during the next few months, there is considerably less agreement on near-term prospects for long-term rates.

From early April to last week, 90-day certificate-of-deposit (CD) rates dropped about 400 basis points. The drop in six-month and 12-month CD rates over the same period was even more precipitous—about 450 basis points. As a result, the yield curve for the CD market is now significantly downward sloping, in contrast to its upward-sloping shape three weeks ago. For example, the secondary market rates on one-month, three-month, and six-month CDs on April 23 were 14.60%, 14.15%, and 13.65%, respectively, while on April 4 they were 17.65%, 18.25%, and 18.30%.

The current CD yield curve suggests that market participants expect short-term CD rates to fall in coming months. Otherwise, the expected return from purchasing shorter-term CDs and rolling them over at maturity would significantly exceed that from purchasing long-term CDs. For example, 90-day CD rates three months from now would have to be about 12¾% or less in order for such a rollover strategy to yield a lower return than that obtained from purchasing a six-month CD.

The interest rate futures markets also suggest a market expectation of further declines in short-term rates. Rates on both Treasury-bill futures contracts and commercial-paper futures contracts maturing from June 1980 on are well below current spot interest rates.

In the bond market, long-term rates also dropped sharply, with 20-year Aa utility rates falling about 125 basis points since early April. Here, however, there appears to be a wide range of views as to whether this rate decline will continue. On the one hand, the combination of the recessionary outlook and expectations of further declines in short-term rates suggests lower bond yields. On the other hand, the magnitude of the recent drop in bond rates may have already reflected these forces. Moreover, the recent market improvement has led a number of corporations to schedule new bond offerings—some of which had been deferred earlier. This potential increase in the supply of corporate bonds could offset any increase in investor demand. It may take some time before there will be indications of whether the bond market can accommodate any significant increase in new bond offerings at current or lower yields.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE O				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	us cr lion
Argentina	Inflation rate continues to decline as government pursues policy of slower devaluation.	Jan.	+ 9%	102.1	$3,825	Mar.	9,821	+133%	18.5	
Bahamas	Restraints placed on sale of Bahamian real estate to foreigners.	Sept.	+ 13%	1.0	4,000	Feb.	87	+ 9%	4.8	
Bolivia	Tax cuts introduced in effort to revive mining sector.	Nov.	+133%	4.7	930	Feb.	112	— 39%	1.6	
Brazil	Inflation ran at a high rate through March, but the economy now shows signs of cooling.	Feb.	+ 31%	209.1	1,760	Dec.	8,966	— 24%	5.5	
Chile	Government emphasizing need for profitability of state enterprises.	Dec.	+ 64%	19.0	1,710	Feb.	2,166	+ 68%	6.4	1
Colombia	Credit controls eased; economic activity continues at brisk pac	Jan.	+ 14%	28.7	1,100	Feb.	4,015	+ 63%	14.3	
Costa Rica	Economic adjustment program implemented in connection with IMF standby loan.	Dec.	+ 27%	3.9	1,790	Jan.	103	— 49%	0.9	
Dominican Rep.	Economic development plan for 1980-82 includes expanded role for foreign investment.	Jan.	+ 66%	5.3	1,000	Feb.	186	+ 68%	1.7	1
Ecuador	New production of autos, trucks, and utility vehicles is underway.	Jan.	+ 73%	8.7	1,070	Feb.	805	+ 32%	5.0	
Guatemala	Minimum wage increase of 186% in agricultural sector causing concern, especially for coffee growers.	Dec.	+ 9%	7.2	1,060	Feb.	702	— 12%	6.1	
Guyana	Real economic growth fell 2% in 1979, the result of shortfalls in bauxite, sugar, and rice.	Dec.	— 3%	0.5	625	Nov.	15	— 80%	1.0	
Jamaica	Bauxite production levy lowered to boost output; election pushed up to August.	Sept.	— 3%	2.7	1,230	Jan.	126	+ 49%	1.6	3
Mexico	Oil output rate to be raised 10% above earlier plans; economic momentum strong.	Feb.	+ 73%	117.9	1,700	Nov.	1,927	+ 10%	1.9	1
Panama	Light assembly and processing industries adding to employment potential.	Nov.	+ 15%	2.7	1,420	Jan.	114	— 38%	4.6	
Paraguay	Inflation rate subsides in January, but is still above 30%.	Dec.	— 10%	3.7	1,225	Feb.	605	+ 30%	13.9	
Peru	Severe drought expected to reduce agricultural output substantially.	Dec.	+ 77%	12.1	700	Jan.	695	+143%	5.5	4
Uruguay	Output in industrial sector rose 8.5% in 1979, the highest rate in two decades.	Nov.	+ 19%	7.2	2,500	Dec.	381	+ 33%	6.0	
Venezuela	Salaries bill calling for generous pay increase recently passed.	Nov.	+ 53%	46.1	3,385	Jan.	6,816	+ 25%	6.9	

Recession Alone Won't Cure Inflation

Now that President Carter has enlisted fiscal and monetary restraint in the fight against inflation, some of his critics contend that the real foot-soldiers in the battle will be the growing ranks of the unemployed. A recession and higher unemployment are likely to result from the policies aimed at curbing inflation. Indeed, a recession may already be under way. But the depth of this recession—as well as the extent of any improvement in inflation—will depend in large part on two vital psychological elements: how firmly inflationary expectations are ingrained, and how credible the public perceives the Administration's policies to be.

Fiscal and monetary policies combine to set the overall level of demand in the economy, along with the public and private shares in total spending. But there are many other influences on productivity gains and real economic growth. Accordingly, restrictive policies could be consistent with many possible combinations of real growth and inflation. For the economy to grow at its potential rate in the face of restrictive policies, price and wage increases must moderate. But if expectations of future inflation are so deeply embedded that prices and wages resist such moderation, then the policies will result only in lower real growth and higher unemployment.

Inflation rates have fallen during and just after past business downturns, but the improvements have been short-lived. As unemployment rises in a recession, slackness in labor markets moderates wage demands. Slower wage gains, together with falling demand for these products, help to ease price hikes. The cyclical behavior of labor productivity reinforces this effect, since productivity usually improves during a recession, also easing pressure on prices.

Stop-and-go fiscal and monetary policies have accentuated the cyclical behavior of inflation in the last 15 years. The first effects of restrictive fiscal and monetary policies are on business activity, and only much later on inflation. Restrictiveness, generated by inflation fears, led to downturns in the economy in 1969 and 1974. But by the time these policies began to take their toll on inflation, the authorities shifted course and adopted stimulative policies to fight unemployment. The result was another surge of inflation.

Considering this past record, it is not surprising that Americans so far have been unwilling to take the Government's commitment to fight inflation very seriously, and have thus resisted lowering their expectations about future inflation. It appears that at least several years of consistent anti-inflation policy will be necessary to alter these expectations significantly. In the interim, unemployment may well climb higher than it is now. However, if the anti-inflation policies are maintained, even in the face of deepening recession, the long-run economic costs of lost output (and employment) will be far less than if the course is reversed again. The path will then be paved for more sustained real economic growth in the future.

PAYMENTS		MONEY AND BANKING							COUNTRIES
of IMF t, mil- f dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate April 23, 1980	exchange rate in U.S. dollars April 23, 1980	current monetary conditions	
	Imports up 55% in January.	Mar.	+119%	Dec.	+206%	—	.00061	Domestic liquidity increases.	Argentina
	Non-oil exports show strong gain.	Jan.	+ 12%	Sept.	+ 5%	—	1.01	Prime rate raised from 9% to 11%.	Bahamas
	Multilateral bank loans of $100 mn. will help cover current-account gap.	Nov.	+ 20%	Nov.	+ 45%	—	.0520	Credit growth limited.	Bolivia
	Farm exports may aid the trade balance.	Mar.	+ 84%	Feb.	+ 74%	33.00%	.0220	Cruzeiro loans very limited.	Brazil
	Exchange rate indefinitely fixed at 39 pesos per U.S. dollar.	Feb.	+ 39%	Aug.	+ 48%	—	.0275	Private money supply expands slowly.	Chile
	Exchange-rate policy changes include faster devaluation pace.	Dec.	+ 26%	Jan.	— 26%	20.00%	.0260	Cash reserve rule of 100% removed on new deposits.	Colombia
	Trade gap was $650 million in 1979; Government allocates funds to spur exports.	Dec.	+ 13%	Dec.	+ 42%	8.00%	.1200	Interest rates lowered.	Costa Rica
	High sugar prices boost export earnings, but oil import bill is huge.	Dec.	+ 26%	Sept.	+ 9%	—	Par	Credit growth limited.	Dominican Rep.
	Petroleum exports show large increase.	Jan.	+ 11%	Nov.	+ 43%	8.00%	.0400	Domestic credit availability limited.	Ecuador
	Tourism down 25% in first quarter of 1980 from year-earlier level.	Dec.	+ 14%	Dec.	+ 25%	—	Par	Tight credit policy prevails.	Guatemala
	Consumption tax placed on imports.	Dec.	+ 16%	Dec.	+ 29%	10.50%	.4000	Private-sector credit increases.	Guyana
	International commercial banks agree to maintain existing payment terms.	Dec.	+ 18%	Dec.	+ 21%	11.00%	.5800	Bank liquidity scarce.	Jamaica
	Government rejects GATT entry.	Mar.	+ 23%	Dec.	+ 31%	4.50%	.0450	Domestic interest rates move higher.	Mexico
	Canal earnings up 9% in 1979.	Nov.	+ 10%	Dec.	+ 23%	—	Par	Credit growth is strong.	Panama
	Cotton exports decline.	Jan.	+ 34%	Dec.	+ 30%	—	.0080	Private credit growth below inflation rate.	Paraguay
	External sector continues to register remarkable growth.	Oct.	+ 64%	Sept.	+ 36%	29.50%	.0040	Domestic liquidity growing excessively.	Peru
	Government seeks to raise wool output by 15% over next five years.	Oct.	+ 73%	Oct.	+ 84%	—	.1190	Credit growth is high.	Uruguay
	First-quarter oil export volume down 15% from year-earlier level.	Dec.	+ 21%	Nov.	+ 4%	8.50%	.2335	Restrictive credit policy prevails.	Venezuela

World Interest Rates

market rates of April 23, 1980; bond yields as of April 18, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 large banks 16.00	15.96	17.00	14.00	9.50	7.00	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	16.50 April 24	17.00	16.75	16.70	12.875	9.00	17.00	10.25	7.00	12.375
Treasury Bills 91-day, Middle Rates	12.05	15.40	16.00	17.25	n. a.	n. a.	14.50 126-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	13.00 finance paper	15.50 finance paper 15% tax w/h	15.16	13.90 Certified	13.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.35	15.40 15% tax w/h	16.5625	15.25 Certified	not traded	9.40	18.40	no market	0.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.79	12.30	13.87	11.03 20% tax w/h	12.78	9.14	14.93	10.25	5.07	10.17
Industrial Bonds prime, long-term, new and old issues, average yield	11.90 Aa Industrials	12.875	14.83	14.54	14.50	9.20	14.70	11.43	5.99	7.89
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	17.25	18.00	18.75	14.85	10.75	20.00	13.00	5.50	9.25
Bank Time Deposits 3-month	14.375 Cert. of Dep.	15.40 Cert. of Dep.	17.25	17.00	12.9375	9.85	10.75	10.50 large deposits	7.00 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	16.4375	no market	17.625	no market	13.00	9.00	no market	10.25	6.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8455	2.2745	.03400	.2360	.5479	.001167	.4961	.5902	.004117
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.625 *P*	1.00 *D*	.625 *D*	3.125 *P*	6.875 *P*	1.125 *D*	6.00 *P*	9.375 *P*	2.75 *P*

Eurodollar Deposits
(London, interbank, bid)
April 24

7-day	16.6875
1-month	15.625
3-month	16.3125
6-month	15.125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.73
U.S.-Canada Treasury Bills	−3.20
U.S.-Canada Finance Co. Paper	−1.29
Eurodollars-U.K. Local Auth. Deposits	− .19

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.50
Over 7 yrs.	12.00
DM Bonds	
7 yrs. and under	10.00
Over 7 yrs.	10.00

Gold Price
London afternoon fixing
506.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.7 (Mar.)	9.4 (Feb.)	19.8 (Mar.)	13.4 (Feb.)	5.8 (Mar.)	21.8 (Feb.)	3.9 (Mar.)	7.2 (Mar.)
Industrial production*	−1.2 (Mar.)	4.1 (Feb.)	−1.4 (Feb.)	3.8 (Feb.)	7.7 (Feb.)	12.0 (Feb.)	4.0 (Dec.)	12.3 (Feb.)
Trade balance† *(billions of local currency units)*	−$5.57 (Feb.)	C$.82 (Feb.)	−£.18 (Mar.)	−FF5.85 (Mar.)	DM.460 (Feb.)	−Lit.1,260 (Feb.)	−SF1.23 (Mar.)	−¥9.9 (Mar.)
Money supply (M_1)*	7.8 (Mar.)	12.9 (Mar.)	5.9 (Mar.)	9.5 (Jan.)	−1.1 (Feb.)	25.5 (Nov.)	−11.1 (Jan.)	7.0 (Feb.)
Velocity of money (M_1)*	3.9 (Dec.)	5.2 (Sept.)	4.8 (Sept.)	11.5 (Sept.)	4.1 (Dec.)	−3.1 (June)	n.a.	− 2.2 (Sept.)
Reserves minus gold *($ million, change from previous month)*	−123 (Feb.)	+415 (Feb.)	+24 (Feb.)	+545 (Feb.)	−2,552 (Feb.)	−655 (Feb.)	+293 (Feb.)	−655 (Feb.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

The Foreign Impact on Monetary Policy

Central bankers throughout the world share the common goals of promoting production, fighting inflation, and maintaining a healthy exchange rate through the use of monetary policy. More recently, the monetary authorities in several countries, notably the United States, have moved to an "aggregate" or "monetary-base" target policy to achieve these goals. By doing so, these central bankers implicitly acknowledge the existence of a stable relationship between money, prices, interest rates, and income.

The experience of the various central bankers has been quite different. Although Germany has continually experienced higher-than-targeted money growth, it has contained inflation fairly well. The United States, however, has had lower money growth targets than Germany in recent years, but has continually overshot these targets and suffered high and accelerating rates of inflation. Two lessons emerge from the collective experience of the Western world's monetary authorities: (1) It is more difficult to meet targets than to set them, and (2) the inflationary consequences of meeting or not meeting targets are uncertain, at least in the near term.

The explanation for the generalized failure to meet monetary targets and control inflation and exchange rates may be found in the monetary authorities' interpretation of the "money demand function," which specifies the determinants of aggregate demand for a particular country's currency. Most national monetary authorities look at the *domestic* demand for money in setting targets and designing policy. However, under present world money market conditions, a more comprehensive money demand function is needed—one that incorporates both *domestic* and *foreign*, or *external*, demand for an individual nation's currency. One need only point to the world reserve currency role of the U.S. dollar and the increasing reserve role of the German mark to underscore the importance of foreign demand for the stronger currencies.

Any analysis of money demand functions must begin with the reasons for holding money. Generally, money is demanded for three purposes: transactions, precautionary, and speculative. The most important variable to consider when analyzing the demand for money, however, is the speculative motivation, since it is the most volatile and least understood. In most statistical models of money demand, the interest rate is used to "explain" much of the speculative motivation. Thus, when central bankers use interest rates as an instrument to implement a monetary policy, they are assuming some degree of predictable responsiveness of money demand to interest-rate changes. However, if one acknowledges both domestic and foreign demand for money, two questions arise: How does the responsiveness of foreign demand for a currency differ from domestic demand, and how are exchange-rate expectations factored in? Monetary policies are very likely to affect domestic and foreign demand for a currency in different ways. It is therefore important that the monetary authorities recognize the elements impinging on speculative demand—which is a key variable in any distinction between domestic and foreign demand for money—before they target the monetary aggregates. Moreover, they must consider the exchange-rate implications of any policy decision.

One indicator of the external demand for a currency is the *velocity* of money, i.e., the speed with which a nation's money stock is turned over each year. The velocity of the U.S. dollar, once considered to be on a downward long-run trend, is now rising sharply, while velocity of the German and certain other currencies has been either falling dramatically or remaining relatively flat. There are many influences on velocity. But the sharp contrasts in velocity movements between the United States, on one hand, and Germany and Switzerland on the other, may be the result of the continued erosion of the foreign demand for U.S. dollars and the increasing roles of the mark and Swiss franc in world financial markets. Reduced demand for dollars, for example, fosters increased velocity as foreigners turn over their dollar holdings more quickly, rather than retain them and risk further depreciation.

It is therefore crucial that central bankers understand why and to what degree foreign demand affects their ability to implement policy, since they must be able to forecast inflation, income, and exchange-rate movements accurately. For example, a central bank may estimate that a growth target of 5% is appropriate for certain monetary aggregates. But if external demand for its country's currency is falling rapidly, velocity will rise and the inflationary impact of the policy supporting this target may be much greater than expected. Indeed, if the 5% target were set assuming no decline in external demand, the policy might increase the inflation rate more than anticipated, damage the nation's currency on foreign-exchange markets (possibly accelerating the fall in demand further), and undermine the credibility of announced policy.

Thus, the monetary authorities must now begin to consider the foreign component of money demand—its magnitude and stability—when setting policy. Both domestic and external demand must be considered when setting policy targets and, more important, when implementing the policies supporting the targets. The time has clearly come for new ground rules to keep pace with the growing internationalization of currencies.

D. Sykes Wilford

A Turning Point for Euroloan Spreads

Interest-rate spreads on Euromarket loans are now on an upward trend, apparently having hit their trough in the final quarter of 1979. Such spreads, or mark-ups, over the London Interbank Offer Rate (LIBOR) had fallen to ¾% and ½% for prime borrowers and to below 1% for certain relatively less creditworthy borrowers.

Determining the accurate price of Euromarket loans is a very difficult task. While the spread over LIBOR is a very visible and important price feature, it is only part of the story. Other price elements include front-end fees, grace periods, and repayment terms. Thus, as spreads begin to widen, fees, grace periods, and maturities should change as well. Indeed, there is already some evidence suggesting that front-end fees are rising rapidly. Moreover, grace periods are disappearing, and maturities are shortening. But while changes in these areas may moderate increases in spreads in the short run, they are not expected to temper the upward movement of spreads over the longer term.

All of the relevant Euroloan price factors continue to adust to significant changes in the international capital environment. Perhaps the most critical development has been the sharp rise in lending risks stemming from OPEC oil pricing. OPEC pricing suggests an aggregate surplus of over $100 billion this year, which alters dramatically the financing requirements of many borrowers dependent on Euromarket funds. Although not all borrowers will be affected by higher oil prices—loans to certain multinational borrowers, for example, are no less risky than in 1977 or 1978—several countries are finding themselves saddled with large (and perhaps not so temporary) current-account deficits that have hurt their implicit risk ratings. Certain country borrowers may thus face sharply higher spreads as they seek selective reschedulings of their debts.

Aside from increases in risk, decreased bank competition is also exerting upward pressure on spreads. The most notable development in this regard was the Japanese Government's directive to its banks last year to halt temporarily their Eurolending activity.

Another important influence on Euroloan spreads is the absolute level of U.S. dollar interest rates. The level of U.S. rates is expected to decline in the second half of the year as the long-awaited U.S. recession begins to affect credit demands and reduce inflation. With the level of short-term interest rates heading down, spreads can rise more easily. This is because borrowers anticipate lower interest-rate costs associated with Euroloans, owing to expectations of declines in LIBOR. Lenders may thus seize the opportunity to boost spreads, since the average spread increase is small relative to the LIBOR declines expected.

Nonetheless, an accurate assessment of just how high spreads will climb is difficult to provide. New lending volume has been weak, as national borrowers are drawing down reserves and utilizing short-term trade credits. However, borrower reliance on short-term credit will diminish as capacity constraints are reached.

Furthermore, the role of the multilateral lending institutions remains unclear. The World Bank, for example, has now become involved in "program" as opposed to "project" financing, which mandates it to assist selected countries with current-account problems by financing imports that enhance export earnings. Such lending is clearly a step toward balance-of-payments assistance.

In sum, the headline-breaking news of record Euroloan spreads has not yet come. But evidence indicates that the downturn in Euroloan spreads has definitely ended, and that the direction of change is unambiguously up for many Euromarket borrowers.

Bluford H. Putnam

Eurocurrency Market

($ billion, end of period)

Total Market Size	IQ/79	IIQ/79	IIIQ/79	IVQ/79	1978	1979	1980
Gross Size (Claims)	883.3	946.6	1,041.5	1,070.0	892.7	1,070.0	1,340.0
Net Size (Claims)	550.0	585.0	635.0	655.0	535.0	655.0	820.0
Liabilities to Private Nonbanks	145.0	155.0	165.0	170.0	140.0	140.0	210.0
Claims on Private Nonbanks	285.0	295.0	310.0	320.0	280.0	320.0	365.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	226.5	243.8	260.8	273.4	222.7	273.4	330.0
Liabilities to Private Nonbank Foreigners	55.0	57.6	61.9	62.3	54.8	62.3	72.0
Total Claims on Foreigners	291.2	306.1	330.7	338.6	293.0	338.6	420.0
Claims on Foreign Public Borrowers	35.7	36.1	39.6	41.3	33.9	41.3	55.0
Claims on Foreign Private Nonbank Borrowers	103.5	107.6	113.1	118.6	104.2	118.6	140.0

Note: Gross and *net* Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.